

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MIC:DET:TL-N-1224-00
KJWebb

date:

to: Chief, Examination Division, Michigan District
attn: [REDACTED], International Agent, [REDACTED]

from: District Counsel, Michigan District, Detroit

subject: [REDACTED]; I.R.C. § 863(b) Sales

This memorandum is in response to your recent request for advice concerning the application of I.R.C. § 863 to the facts as addressed below. The advice in this memorandum is subject to 10 day post-review in the National Office.

ISSUE

Whether [REDACTED] is entitled to avail itself of I.R.C. § 863(b) treatment as a result of the production activities performed by its Mexican subsidiary, [REDACTED]

[REDACTED], thereby allowing [REDACTED] to apportion its gross income as foreign source income from the sale of the products produced and assembled at [REDACTED].

FACTS

In [REDACTED] purchased the [REDACTED] [REDACTED], which is now known as [REDACTED]. [REDACTED] consists of an integrated U.S. and Mexican operation. The Mexican component of [REDACTED] is made up of the [REDACTED]. [REDACTED] is a separate legal entity which is incorporated under the laws of Mexico. [REDACTED] is a wholly owned subsidiary of [REDACTED], which is a wholly owned subsidiary of [REDACTED]. [REDACTED] directly owns its physical plant, and land. In addition it also employs approximately [REDACTED] Mexican employees, who assemble [REDACTED] components. [REDACTED] owns the equipment located within the [REDACTED] and employs approximately [REDACTED] management level employees, who are based at the [REDACTED].

The agreement between [REDACTED]'s U.S. and Mexican operation provides that [REDACTED] will ship [REDACTED] to [REDACTED],

on consignment, for [REDACTED]. Upon completion, [REDACTED] returns the [REDACTED] to the U.S., where they are sold. [REDACTED] contends that its management responsibilities over [REDACTED] create a principal-agent relationship. Thus, [REDACTED]'s production activities are then imputed to [REDACTED]. Hence, [REDACTED] maintains that it is the entity which is producing inventory property from without the United States.

STATUTORY AUTHORITY

Internal Revenue Code § 863(b) provides that "in the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment proscribed by the Secretary, Gains profits and income . . . from the sale or exchange of inventory property by the taxpayer within and sold or exchanged without the United States or produced (in whole or in part) by the taxpayer without and sold within the United States . . . shall be treated as derived from sources within and partly from sources without the United States."

I.R.C. § 863(b).

ANALYSIS

Treasury Regulations § 1.863-3(c)(1) provides some guidance with respect to what type of activities fall within the scope of "production activity" as intended by I.R.C. § 863(b). There it states "[f]or purposes of this section, production activity means an activity which creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. Subject to the provisions in Treas. Reg. § 1.1502-13 or Treas. Reg. 1.863(g)(2)(ii), the only production activities that are taken into account are those conducted *directly* by the taxpayer."

Despite the common meaning of the term directly, "in a direct line or way; without intervention; exactly or completely Webster's New Riverside University Dictionary 381 (2nd Ed. 1994)., the taxpayer has interpreted the term directly to include production activities carried out by subsidiaries that may be imputed to it as a result of an agency relationship, which [REDACTED] argues has arisen by virtue of the parent entities management of

the subsidiary's production activity. The taxpayer has pointed to no case law to support its position.

Although Revenue Ruling 75-7 does not specifically address I.R.C. § 863(b), it does raise the issue of whether activities of an unrelated entity may be attributed to another entity, by virtue of a principal-agent relationship, under the international provisions of the Internal Revenue Code. Rev. Rul 75-7, 1975-1 C.B. 244. In Revenue Ruling 75-7, the service opined that a Controlled Foreign Corporation (CFC) that entered into an arm's length contract with an unrelated foreign manufacturer, whereby the manufacturer agreed to provide manufacturing services for the CFC, will be treated as if the manufacturing activity was conducted by the CFC through a branch for purposes of determining Foreign Based Company Income under I.R.C § 954(a).

Notwithstanding Revenue Ruling 75-7, the Tax Court has held that a manufacturing corporation unrelated to a CFC cannot be a branch or similar establishment of the CFC. Ashland Oil Co. v. Commissioner, 95 T.C. 348 (1990); Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990). Hence, the position asserted by the taxpayer is unsupported by the Tax Court. Moreover, Revenue Ruling 97-48 recently revoked the position announced in Revenue Ruling 75-7. Thus, Revenue Ruling 75-7 cannot serve as a source of authority for [REDACTED]'s argument that it is entitled to 863(b) treatment.

A exhaustive review of case law interpreting Treas. Reg. § 1.863-3(c)(1) revealed no case law which specifically addressed the meaning of the term directly. Nevertheless, such search did uncover a case which addressed the standard of interpretation that should be applied with respect to Treasury Regulations. Phillips Petroleum and Affiliated Subsidiaries v. Commissioner, 101 T.C. 78 (1993). In Phillips, the Court was called upon to determine which allocation method should be imposed under I.R.C. § 863 on income derived from sources partly within and partly without the United States. In reaching its decision the Court stated that

"with respect to the interpretation of statutes [it has] employed the rule that statutes are to be construed so as to give effect to their plain and ordinary meaning unless to do so would produce absurd or futile results, and where a statute is clear on its face, we require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein. . . . In particular, administrative rules are to be construed to effectuate the intent of the enacting body, see United States v. Larinoff, 431 U.S. 864, 872 (1977); Rucker v. Wabash R.R. Co., 418 F.2d 146 (7th Cir.

1969)." .

Phillips, 101 T.C. 78, 97 (1993).

After discussing Treasury Regulation 1.863-3(c)(1) with its author, Anne Shelburne, it is clear that it was intended for the term *directly* to be given its plain and ordinary meaning. Hence, production activity conducted on behalf of [REDACTED], by [REDACTED], is not within the scope of production activities, which are entitled to I.R.C. § 863(b) treatment. Furthermore the holdings in Ashland Oil Co. v. Commissioner, 95 T.C. 348 (1990) and Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990) illustrate the Tax Court's reluctance to confer benefits under the international provisions of the Internal Revenue Code to entities based on imputed conduct stemming from agency relationships. Thus, it is the recommendation of this office that production activities conducted by the [REDACTED] may not be treated as the production activities of [REDACTED]. Hence, [REDACTED] is not entitled to I.R.C. § 863(b) treatment as a result of the production activities performed by its Mexican Subsidiary, [REDACTED].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

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If you have any further questions concerning this matter, please feel free to telephone the undersigned, Kimberly J. Webb, at 313-237-6427.

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By: _____
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Attorney